79-120

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1979

THOMAS S. CARPENTER, ELLIOTT TAYLOR, ELDO GROGAN, WILLIAM MILLS, and GENE PATTON,

*Petitioners*

v.

EDWARDS AND WARREN, PROFESSIONAL ASSOCIATION; MARK B. EDWARDS; JOSEPH WARREN, III; GRESHAM NORTHCOTT; BETEX CORPORATION, a North Carolina Corporation; HARRIS, UPHAM & COMPANY, INC.; MICHAEL B. ALLRAN; EDWARD R. ANDERSON; A. J. BEALL, JR.; ANNE C. HAWLEY; BARBARA MORGAN; ROBERT S. MORGAN; G. F. PARKER; SAMUEL WHITE; R. W. CANNON; DOMINIC CAPELLI; PAULINE CAPELLI; FRANK W. CAYCE; JOHN GAYLORD, JR.; JOHN A. JENKS; and FRANK MANSHIP,

*Respondents*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit entered on March 13, 1979, rehearing denied on May 2, 1979.

## REFERENCE TO OPINION BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit is reported at 594 F.2d 388 and is attached in the Appendix (pp. 1a to 14a).

## JURISDICTION

The judgment sought to be reviewed was entered on March 13, 1979. The order denying rehearing was entered on May 2, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

## QUESTIONS PRESENTED

1. Is the decision of the Court of Appeals, that liability of a controlling person under Section 15 of the Securities Act of 1933 requires "something more than negligence," in conflict with a controlling decision of this court ("We also consider it significant that each of the express civil remedies in the 1933 Act *allowing recovery for negligent conduct,* see §§11, 12(2), *15,* 15 U.S.C. §§77k, 77l(2), 77o, is subject to significant and procedural restrictions * * * " 425 U.S. 185 at 208 (emphasis added)) and therefore erroneous?

2. Is control under Section 15 negated as a matter of law where a brokerage firm knowingly permitted and failed to prevent continuation of sales by its former registered representative (proscribed by Section 5 and actionable under Section 12) of the identical form of unregistered securities that he was selling prior to the termination of his employment, as disclosed to the firm in mail directed to him at the office and opened and examined by his supervisor, the details of which were withheld from the firm's compliance officer and from the



New York Stock Exchange, which was falsely informed in a required report that the registered representative, during his employment, was not known to have violated the Securities Laws and when, had the facts been disclosed, an investigation would have been made which would have resulted in the termination of the sales and have prevented the sales in question to the petitioners through injunction at the instance of the Securities Exchange Commission or the voluntary act of the registered representative who was ignorant of the illegality?

3. Did the Court of Appeals err in holding that there is no issue of fact upon which to base a recovery against Harris, Upham and that Harris, Upham is entitled to judgment as a matter of law?

## STATUTES INVOLVED

The statute involved is Section 15 of the Securities Act of 1933, 77 U.S.C. 77o, reading as follows:

"§77o. Liability of controlling persons

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had *no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.*" (Emphasis added)

Involved in the interpretation of that section are Sections 2, 5, 12, 13, 15, 19, 20 and 22 of the 1933 Act, codified as 15 U.S.C. Sections 77b, 77e, 771, 77m, 77o, 77s, 77t and 77v; and Sections 2, 3, 4, 5, 6, 15, 15A and 21 of the 1934 Act, codified as 15 U.S.C. Sections 78b, 78c, 78d, 78e, 78f, 78o, 78o-3 and 78u. Copy of the pertinent parts of these statutes is contained in the Appendix hereto (pp. 15a to 28a).

## STATEMENT OF CASE

The case in the Court of Appeals involved three actions initiated in the United States District Court for the Western District of North Carolina, claiming jurisdiction under Section 23 of the Securities Act of 1933, 15 U.S.C. Sec. 77v as pertinent here. Plaintiffs sued the alleged sellers of unregistered securities and joined Harris, Upham & Company, Inc. alleging its liability as a controlling person under Section 15 of the Securities Act of 1933, 15 U.S.C. 77o, as well as other statutes no longer relied on as to it. The petitioners herein were plaintiffs in two of the actions. The actions were consolidated for discovery. Upon motion of Harris, Upham, the District Court granted summary judgment in favor of Harris, Upham against the plaintiffs and also against the defendants Edwards and Warren, who alleged cross actions for indemnity and contribution against Harris, Upham. On appeal of the plaintiffs and Edwards and Warren, the Court of Appeals affirmed. This petition is filed by Carpenter and Taylor who were appellants in case number 77-2051 in the Court of Appeals and by Grogan, Mills and Patton who were appellants in number 77-2181 in the Court of Appeals. The respondents consist of the defendants in the three actions and the plaintiffs in the third action who were the appellants in case number 77-2182 in the Court of Appeals.



The evidence bearing on the liability of Harris, Upham, in the light most favorable to the petitioners, is summarized as follows:

In 1973 and 1974 McKinney Cattle Company, with headquarters in Hutchison, Kansas, was engaged in the purchase, fattening and sale of cattle in Kansas and Oklahoma (A-25).

Gresham Northcott was a registered representative of Harris, Upham, a brokerage firm which was a member of the New York Stock Exchange (A-25). Harris, Upham admits (A-35) that the rules of the Exchange were as set out in the Fifth Amendment to the complaint (A-9-15). These rules are copies in the Appendix hereto (pp. 29a to 34a). Under the statutes set out in the Appendix, these rules had to have the approval of the Securities and Exchange Commission. Harris, Upham further admits (A-140) that it is regulated by the Securities Acts of 1933 and 1934 and obligated to abide by the rules of the New York Stock Exchange.

In the fall of 1973, Northcott discussed with defendants Edwards and Warren, Attorneys, investments in cattle contracts with McKinney and exhibited to them a form of letter contract. Edwards and Warren prepared a revised form which was the form used for the contracts in suit (A-25-27). Neither the letter contracts nor the revised contracts were registered as a security (A-26 and 27). The two contracts purchased by the petitioner Carpenter and sued upon in this action appear at A-750-755. Copy of one of these contracts is contained in the Appendix hereto (pp. 35a to 37a). The contracts of the other petitioners now relied upon were on the identical form and involve cattle. All petitioners' contracts were entered into in 1974, after Northcott left Harris, Upham. Claims of Patton on grain contracts against Harris, Up-

ham are abandoned. (Northcott did not sell any grain contracts until after he left Harris, Upham).

Northcott resigned as a representative of Harris, Upham on January 17, 1974, effective February 1, 1974 (A-745). While still employed, he had been instrumental in producing many cattle contracts for McKinney on the same forms as those in suit. Three such contracts dated November 1, 1973 appear at A-757-765. These three, with copy of a letter from Joseph Warren, III to McKinney dated November 28, 1973 (A-756(g) and 756(h)) were sent to Northcott at Harris, Upham's office (A-445). Copy of the letter of November 28, 1973 and of one of the enclosed contracts is contained in the appendix hereto (pp. 40a to 42a). At that time Claude L. Ives, Jr. (hereinafter called Ives) was a branch manager of the Charlotte office of Harris, Upham. As such he was required to be familiar with the securities laws and the regulations of the various exchanges and he testified that he was familiar with all the rules and regulations (A-554). He had the responsibility of supervising the conduct of actions of representatives such as Northcott (A-575).

Ives testified as follows (A-588):

"Q What steps did you take to police Mr. Northcott or his activities from September of '72 until the time he was terminated?

A I checked all incoming mail into the office. It was all opened and read. I checked all outgoing mail and initiated all correspondence leaving our office. I checked all monthly statements at least quarterly, usually monthly. I looked at every daily activity sheet or blotter with the idea of examining every trade that was made in the office. Those are the basic steps."



Northcott testified (A-446 and 447) that whoever opened the mail and his copy of the letter of November 28, 1973, if he looked at it, could have seen the exact terms of each of the three agreements, referring to the letter of November 28, 1973 appearing at A-756(g) and 756(h) and the three agreements appearing at A-757-765.

Other similar correspondence which came to Northcott and was opened and read by Ives is set out in the record (A-756 and 757; A-755(a) and 756(b)).

This correspondence disclosed to anyone who read it that contracts on this form were being offered to the public, each contract showing on its face that a form, with blank spaces filled in, was used.

The fact that Northcott was engaged in participation in the sale of McKinney cattle contracts was common knowledge in Harris, Upham's office, to such an extent that Northcott was called "cattle baron" (A-748).

When Northcott resigned on January 17, 1974, the rules of the New York Stock Exchange required Harris, Upham to, and it did, submit a Notice of Discontinuance of Registered Employee. The form submitted is Exhibit 375 (A-744), known as form RE-4. Copy is contained in the Appendix hereto (p. 43a). The question "Within your knowledge and the records of your firm, was he (she) *ever* subject of * * * or has he (she) ever * * * (e) violated any provision of the NYSE Constitution or Rules or of any securities law or regulation * * * ?" was answered "no". The answer to paragraph 8(e) was false in that:

(a) Northcott had violated a rule of the Exchange to the knowledge of Harris, Upham in his activities relating to McKinney cattle contracts;

(b) He had violated provisions of the securities laws in that he had sold unregistered securities. There is ample evidence to support a finding of fact that Harris, Upham through Ives had knowledge of the exact terms of the cattle contracts Northcott was engaged in selling. Evidence hereinafter recited rebuts any finding that Harris, Upham had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of Northcott existed.

After his resignation, Northcott continued to sell the identical kind of cattle contract to customers of Harris, Upham and members of the public, including the petitioners, one of whom was Carpenter who was known by Harris, Upham to be so dealing with Northcott.

The following colloquy between Judge Hall of the Court of Appeals and Mr. Abrams, counsel for Harris, Upham, quoted from a transcript of the argument in the Court of Appeals, tends to show that the sufficiency of the evidence to support a finding of actual knowledge on the part of Harris, Upham of the facts on which the liability of Northcott was based was recognized by the Court and Harris, Upham's counsel:

"JUDGE HALL: Let me ask you: Could the evidence have been construed by anybody that Harris, Upham knew all about Northcott's activities?

MR. ABRAMS: At particular points in time, yes. But that's the problem with the way this is set up. I set out in the brief—

JUDGE HALL: But at any time, under any stretch, could the evidence be construed, any rationing basis to be construed—



MR. ABRAMS: Yes, sir, I think so.

JUDGE HALL: You think so?

MR. ABRAMS: Yes, sir, I think so.

JUDGE HALL: If that's true, I assume they had an obligation to tell about it? (Inaudible)" (pp. 35 and 36).

Harris, Upham admitted in its brief in the Court of Appeals for purposes of the appeal that the contracts sued upon by the petitioners "were unregistered investment contracts and 'securities' sold in violation of Section 12(1) and 12(2) of the Securities Act of 1933." That Northcott had sold, while employed, or been instrumental in selling, similar contracts and that these came to the attention of Ives has already been shown.

Prior to Northcott's resignation and prior to the submission of form RE-4, in late 1973, Harris, Upham began to object to Northcott's outside activities pertaining to McKinney cattle contracts. According to Northcott's testimony this objection was never related to violation of a Stock Exchange Rule but was made on the ground that Northcott was not spending enough time in the business of Harris, Upham. He testified that he was not advised that he was violating any rule (A-464, 480, 481, 488). Northcott testified (A-460 and 461) that if Ives had told him his activities were illegal he would have discontinued them immediately. Ives reported general dissatisfaction with Northcott's performance to his superior, Vice-President Robert Q. Jones, as a result of which both Ives and Jones met with Northcott. Jones considered that the outside activities needed scrutiny by the compliance department of Harris, Upham (A-601). Jones, by letter, reported to Ronald J. Veith, Harris, Upham's compliance officer, only some of the facts known to Jones and stated "our in-

vestigation is somewhat incomplete, but, on the basis of the facts presented I would appreciate your advice as to whether Northcott should be given a clean release from Harris, Upham." Copy of the letter of January 21, 1974, Exhibit 355, A-741 and 742 is contained in the Appendix hereto (pp. 45a and 46a).

Veith replied on January 24, 1974 (A-743) to the effect that he saw no reason why Northcott should not be given a clean release from Harris, Upham, remarking that if in the future additional facts were obtained regarding his activities, "we can always forward them to the New York Stock Exchange." Harris, Upham admits that no further investigation was made (A-168 and 196, paragraphs 117). Veith took the position that any further investigation was up to Jones and Jones took the position that it was up to Veith to advise him if any further investigation should be made.

One element of the incomplete investigation was the failure of Northcott to furnish a list of customers of Harris, Upham referred by him to McKinney. Ives, but not Jones or Veith, already knew of at least one such customer, Carpenter.

On deposition, Jones testified that if he had known of the letters coming across Ives' desk, he would have reported them to Mr. Veith who would have told him what to do (A-602 and 603).

In turn, Veith testified to a chain of facts (not mere possibilities as found by the District Court and reasserted by the Court of Appeals) which would have resulted in preventing the illegal sale of securities to the petitioners if Veith had been given all the facts known to Ives and Jones. His essential testimony is set out in the Appendix to the briefs in the Court of Appeals (A-628-652). Pertinent parts are quoted below:



(A-628 and 629)

"A. If one of our Registered Representatives engages in an outside activity which is a kindred business to the securities industries, the business of Harris, Upham, that is a violation of an Exchange Rule, yes, it is.

Q. Well, okay, so if you had known that he was selling these securities, if it's a fact that he was, if that had come to your attention, there would have been a full field inspection, isn't that right?

A. Yes, that is absolutely right.

Q. Not only would Jones have jumped on the plane to go down to Charlotte, but you'd have been down here too, isn't that true?

A. That is true.

Q. And there would have been all kinds questions asked until you got—you'd find out the truth, wouldn't you?

A. I certainly would have.

Q. You would have asked him questions if it took five weeks until you were satisfied that you had the truth, isn't that right?

A. That is correct."

(A-630)

"Q. Now, did I understand you to tell Mr. McClure that if you had been in the position of supervision over Mr. Northcott, and the investigation was incomplete, as Mr. Jones

said in his letter it was, you would have made an investigation, you would have made it complete?

A. That is correct."

(A-633-637)

"Q. Now, Mr. Veith, I hate to repeat, but you would yourself have made a complete investigation. Do you still say that or do you change your testimony about that?

A. Had I been privileged to the information that it is alleged that our Manager had and that our Supervising Officer had, I would have continued the investigation, yes.

Q. Why?

A. Because the information they had was a lot more than I had.

Q. I agree with you, why would you have continued the investigation?

A. Because from the information that these people had, there was a possibility, a greater possibility of the violation of rules or a possibility, let me rephrase that, a possibility of the violation of rules.

Q. You would have made a further investigation if, on the facts known to you, there was a possibility of a rules violation, wouldn't you?

A. I certainly would have.

Q. Yes, sir.

A. Yes.



Q. Now, what was it that you knew—and you have sat through the depositions of both Mr. Jones, and Mr. Ives, have you not?

A. Yes, I have.

Q. So you've heard them tell everything that I've heard?

A. That's correct.

Q. What was it that they knew, that they did not, or Mr. Jones did not tell you?

A. I had no idea that this person that was being—that our salesman was referring people to was one of his accounts."

Q. What difference would that make?

A. That would have, number one, alerted me to either a conflict of interest or, number two, a possible rebate of commissions.

Q. What else was there that they knew, according to what they testified to here this week that you did not know as result of reading that letter?

A. I did not know that Mr. Northcott was put under any pressure at any time. I did not know that Mr. Northcott was taking extended leaves from the office. I did not know that a list of customers had been requested and not furnished. That's what I did not know.

Q. All right, now what difference did it make that he was being pressed for information by the Branch Manager and also by the Supervisor, who is the equivalent of the

Regional Manager in some other firms? What difference did it make that he was being pressured by them for information and wouldn't give it to them?

A. Because under his agreement with the New York Stock Exchange, he has agreed to cooperate fully with any investigation initiated by us, as well as the regulatory authorities.

Q. What difference would it make that he was taking extended leaves of absence?

A. Because we are paying him to be a salesman with Harris, Upham and when he is out of the office, we should know what he is doing and where he is.

Q. Why?

A. Why should we know where he is?

Q. Yes.

A. Because he is not performing his primary function that we are paying him for—why is he not performing that function, where is he?

Q. Would it be interesting to know if he was performing a function that was hurting somebody to whom Harris, Upham had a duty?

A. Well, it would be interesting to me to know whether he was performing a function that was hurting anybody, regardless of whether Harris, Upham had a duty or not.



Q. But you'd be particularly interested if it was possible that he was hurting somebody who was a customer of Harris, Upham?

A. I certainly would.

Q. And you have, of course, an understanding that a number of these rules are designed not to protect the financial status of Harris, Upham but to protect the customers of Harris, Upham and the public, isn't that correct?

A. That is correct.

Q. Now what difference would it have made that the list of customers that he was referring to McKinney was requested and not furnished as separated from just a general refusal to give information?

A. Well, you're talking about a salesman referring customers to an account which he handles, the account which he handles produces commissions and there is a term used in our industry, such as, the term is, 'Soft Dollar Business,' you may have heard it before, you may not. It's mainly directed toward institutions; it is in essence, to put it in layman's terms, 'You scratch my back, I'll scratch yours.' If this was the case, I would have definitely wanted a list of those customers, because I would have called those customers to see if at any point in time Mr. Northcott ever solicited anything to them regarding McKinney Cattle Company. That's why I would have wanted those lists of customers."

(A- 643-645)

"Q. And I'm asking you if an activity, a given activity, make the assumption, if you will, is in violation of Rule 346 and it has the potential of hurting a Harris, Upham customer, which you can conceive, can you not?

A. Yes, I can.

Q. If from Harris, Upham's point of view and your point of view one of the reasons why you enforce that rule, that concept, is to protect the customer, the person who might get hurt?

A. Yes. * * * (L)et's take this information right here, let's assume that I had a conversation with Mr. Jones based on information in this letter and add to that the name of McKinney, being an account of the Registered Representative, at that point, notes would have been taken and investigation would have been initiated with or without Mr. Jones' consent.

Q. Rule 346 requires that every Registered Representative devote his entire time during business hours, in the case of Harris, Upham, to Harris, Upham?

A. That is correct.

Q. It also requires that he shall not at anytime be engaged in any other business, doesn't it?

A. Unless specifically approved by the New York Exchange.

Q. Right. And, of course, there is no question in this case that, with respect to Northcott,



whatever activities he was engaged in, there was no permission from the New York Stock Exchange, you'd have a file on that wouldn't you?

A. Well, let me say that I do not know of any activities that we have approved or that the New York Stock Exchange has approved for Mr. Northcott.

Q. And you would be in a position to know if there had been, would you not?

A. Yes, I would."

(A-647)

"A. * * * I'm very pleased with the functions of the Securities and Exchange Commission. I think they do a hell of a job. I think they are what an investigative, an enforcement body in the securities industry is all about. That's why I feel about the New York Stock Exchange like I do.

Q. All right, now, if I understand the procedures, you, as Compliance Director in charge of the representatives, representation department or whatever you call it, Registration Department, if you have a reportable thing, you don't report to the SEC, you report to the Stock Exchange, and the Stock Exchange reports to the SEC, if it has a reportable thing?" * * *

A. "Well, let me say that is not unlikely. As a matter of fact, I have in the past and will continue in the future to report to the SEC anything that I think is a violation of the '33 and '34 Act.

Q. Direct?

A. Direct, that is correct."

(A-648 and 649)

"Q. In this particular case, the letter which you had from Mr. Jones did not contain complete information. As a result of that, as a routine in your office, the RE-4 Form was, that was exhibited here, was prepared and sent to Mr. Jones, he signed it and it was routinely sent to the New York Stock Exchange?

A. That is correct.

Q. Now, had it reflected the results of a full investigation by you, which would have been made had you had the facts that Mr. Ives and Mr. Jones had, had it reflected an affirmative answer to the question, has he or she ever violated any provision on New York Stock Exchange Constitution, Rules or any securities laws or regulations or violated any of his or her agreements with the Exchange, had either one of those questions or both of them been answered yes instead of no, when the RE-4 got to the New York Stock Exchange, if I understand your testimony, the only thing that would have happened would be a letter to you, a letter to Mr. Jones, and a letter to the Branch Manager, is that right? From the New York Stock Exchange.

A. Well, that is correct, but I could not submit a RE-4 to the New York Stock Exchange



with an affirmative answer without attaching to it the complete details of what happened."

(A-650-652)

"Q. * * * If you had made the investigation that you would have made had you known what Mr. Ives knew and what Mr. Jones knew, and had you determined—I'm not asking you to decide this case—had you determined that there was a violation of the laws and had you reported that on RE-4 together with your full investigation so they wouldn't have to write you three letters back, what would they have done? * * *

A. In all probability, they would have initiated a hearing with Mr. Northcott if he agreed to attend." * * *

Q. * * * I asked you if there was a hearing and if, as result of the hearing, it was determined that he was selling unregistered securities that should be registered in violation of the '33 Act, if as a practical matter—particularly if the man didn't know he was doing that—if it wouldn't as a practical matter put an end to his activity in that respect.

A. Well, I think if the New York Stock Exchange determined that he, in fact, did violate the 1933 Act by selling unregistered securities, it would put an end to his career in the securities business with a Stock Exchange member firm and their investigation would then be referred over to the SEC to

hopefully put an end to his acting in the securities business at all.

Q. And if by chance he didn't really know before the hearing that what he was doing was wrong, and he was basically a decent person, it would put an end to it right there, wouldn't it?

A. Of course, you know, I mean don't do it anymore, yeah, for sure.

Q. That's just plain, ordinary common sense, right?

A. Yes.

Q. Now, I'm interested in your statement that you might report something to the SEC yourself. If your investigation, that you would have made had you had the information that Mr. Ives had and Mr. Jones had, revealed to you that Mr. Northcott was selling unregistered securities in violation of the Act, would you have reported that to the SEC?

A. Yes.

Q. And you have said, I believe, that the SEC, upon receipt of information of that sort, was very efficient and you approved of their operation in enforcing the law.

A. That is correct."

The Court of Appeals recognized that the evidence permits a finding that "at best, Harris, Upham was guilty of simple negligence," Opinion, appendix p. 12a. Veith's testimony alone is sufficient to support such a finding, and further a finding of proximate cause.



## REASONS FOR GRANTING THE WRIT

### I.

Petitioners, Carpenter and Taylor, brought their actions within the one year provided by the 1933 Act and asserted liability of Harris, Upham under Section 15 of that Act in the trial court and the Court of Appeals. They did not assert liability under Section 20 of the 1934 Act in the Court of Appeals. The remaining petitioners, Grogan, Mills and Patton, in addition to reliance on Section 15, also asserted liability under Section 20 of the 1934 Act in the Court of Appeals but abandon that assertion in this court. The Court of Appeals concluded that the standards under both Acts were the same and stated "The controlling persons provisions contain a state-of-mind condition that requires a showing of something more than negligence to establish liability," citing *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 207-209, 96A S.Ct. 1375, 47 L.ed.2nd. 668, (1976) n. 27 and 28. It seems clear that the Court of Appeals thus decided a federal question in a way in conflict with the very decision of this Court on which that Court relied. See Opinion attached, at Appendix p. 10a.

Footnote 28 of the Ernst opinion relied on by the Court of Appeals deals not with Section 15 of the 1933 Act but with Section 20 of the 1934 Act. In the body of its opinion, this Court made it clear that Section 15 of the 1933 Act allows recovery for negligent conduct. We quote from this Court's opinion in that case at page 208 as follows:

> "We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery *for negligent conduct,* see §§11, 12(2),

*15*, 15 USC §§11, 12(2), 15, 15 USC §§77k., 771(2), 77o, is subject to significant procedural restrictions not applicable under §10(b)." (Emphasis added)

## II.

The Court of Appeals decided in effect that control for the purposes of Section 15 of the Securities Act of 1933 cannot extend to any activities taking place subsequent to the employment, though of the same kind begun during employment, notwithstanding knowledge of such activities both during employment and afterward.

The evidence presents as strong a case of control as could be made, with respect to after-employment acts, short of showing active participation by Harris, Upham in the sales in suit. In view of the statutory scheme of the securities laws requiring supervision of individual brokers by brokerage firms and reports of securities laws violations by brokerage firms to stock exchanges for the purpose of preventing sales of unregistered securities, an important question of federal law is presented as to whether liability of a brokerage firm as a controlling person under Section 15 of the 1933 Securities Act can, in any case, be based on the practical ability of the brokerage firm, by proper supervision and accurate reports, to bring about prevention of known illegal actitivies of registered representatives employed by it after leaving its employment which had their genesis during the employment, and which were accomplished through the use of this firm's facilities. This is a question which has not been, but should be, settled by this Court. The District Court and the Court of Appeals avoided meeting this question directly by erroneously finding that the evidence showed mere possibilities that



proper investigation and reports by Harris, Upham could have prevented the illegal sales, whereas the evidence clearly supports a finding of fact that such sales *would have been prevented* had Harris, Upham performed its duties as to supervision and reports. Not only is there evidence that a proper investigation and report *would* have resulted in the illegal activities being reported to the SEC and that the SEC is efficient in enforcement of the securities laws but there is also a presumption in law that the Commission would have performed its duties. 31A CJS Evidence, Section 146, pp. 318-361. The SEC is vested by statute with power to prevent violations of securities laws. 15 USC 77s and 77t, Sections 19 and 20 of the Securities Act of 1933.

## III.

Aside from the control (operative after Northcott resigned) by means of an accurate report to its own compliance officer and to the New York Stock Exchange, Harris, Upham had earlier control over its agent, Northcott, which, if properly exercised, would have put a permanent end to Northcott's illegal actitivies while he was still employed. Northcott testified (A-460 and 461) that if he had been advised that his activities were illegal, he would have discontinued them. Clearly, Harris, Upham's duty of supervision included the duty to advise Northcott that his outside activities, known to his supervisor, were illegal. It also had the duty to its own customers, such as Petitioner Carpenter, to advise them as to illegality of investments being sold to them by its representative to its knowledge. The evidence shows that Ives knew that Carpenter was an investor in McKinney cattle contracts both before and after Northcott's resignation (A-655-657). If Ives had merely suggested to

Carpenter that he take another hard look at these investments, Carpenter would not have bought the contracts in suit (A-667). It is also clear from the testimony of Carpenter (A-670) and that of Taylor (A-678 and 679) that if Carpenter had been alerted to the true facts, it would have resulted in Taylor not buying the McKinney investment in suit. The same may be inferred as to the other petitioners.

Harris, Upham, through Ives, had full knowledge of Northcott's activities while he was employed. If it had performed its duties of supervisor and its obligation to its own customers while Northcott was employed, his illegal activities would have been terminated while he was still employed.

## IV.

There was no showing on motion for summary judgment that the evidence was insufficient to present an issue of fact as to liability of Harris, Upham under Section 15 of the Securities Act of 1933 and the questions of law hereinbefore discussed are clearly presented by the record.

The following issues of fact affecting the liability of Harris, Upham, arise upon the pleadings and, Petitioners contend, upon the evidence:

1. Was Harris, Upham a controlling person of Northcott within Section 15 of the Securities Act of 1933?

2. Did Harris, Upham have knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of Northcott is alleged to exist?



The burden of proof on the first issue is on the Petitioners. It is well settled that the burden of proof on the second issue is on Harris, Upham. The Court of Appeals recognized that the evidence would support a finding of negligence and placed its decision in this respect on the erroneous holding that more than negligence is required. The issue of law is then reduced to the question whether it affirmatively appears that there is no evidence to support an affirmative answer to the issue of control. In holding that it does affirmatively so appear, the District Court treated Veith's testimony as to what he would have done if he had been given the facts known to Ives and Jones as evidence of a mere possibility as distinguished from a fact and treated Veith's testimony as to the practice of the SEC in enforcing the law plus the legal presumption that the SEC would perform its duties as supporting no more than a mere possibility. This erroneous position was adopted by the Court of Appeals.

That Veith's testimony that he would have reported any discovered violation to the SEC was competent is supported by the following authorities:

> Wigmore, Evidence, 3rd, Ed. Secs. 581 and 1963
> *Searfoss* v. *Rr.* 76 F.2nd 762 (CA.3, 1935)
> *United States* v. *Aleli* 170 F.2d 18 (CA3, 1948)
> *Southern Pacific* v. *Libbey* 199 F.2d 341 (CA 9, 1952)

The legal presumption that a governmental agency (here the SEC) will perform its duties applies to anticipated action as well as to action already taken, and, perhaps, with greater force.

> *United States* v. *Tarumianz,* 242 F.2d 191 (CA3, 1957)

Harris, Upham was charged with the knowledge which Ives and Jones had and cannot escape the obligation to act on that knowledge on the ground that these responsible agents failed to disclose their knowledge to Harris, Upham's compliance officer, Veith.

Restatement of Agency, Second, Sec. 275
*Armstrong* v. *Ashley,* 204 U.S. 272, 27 S.Ct. 270, 51 L.ed. 482 (1907)
*Norburn* v. *Mackie,* 262 N.C. 16, 136 SE 2d 279 (1964)

That liability under Sec. 15 of the Securities Act of 1933 is not dependent upon continuation of a relationship of master and servant is supported by forceful reasoning in the District Court case of *Hawkins* v. *Merrill Lynch,* 85 F. Supp. 104 (DCWD Ark., 1949). That heavy consideration is to be given to potential power to influence and control the activities of a person as opposed to the actual exercise thereof is expounded by the Court of Appeals for the Third Circuit in *Rochez Brothers, Inc.* v. *Rhoades,* 527 F.2d 880, 890 and 891 (CA3, 1975).

In these cases Harris, Upham had duties of supervision and reporting under rules of the New York Stock Exchange, by which it was bound, which rules were approved by the SEC before the Exchange could be registered with the Commission. By properly performing its duties under those rules, Harris, Upham had the ability to put into operation a series of occurrences which would have prevented the illegal sales which are the subject of these actions, either because Northcott would have ceased his activities voluntarily on being advised of their illegality, or because he would have been forced to do so by action of the SEC. This should be held sufficient to support a finding of control under Sec. 15 of the 1933 Act, and to preclude dismissal by Summary Judgment.



## CONCLUSION

Everyone on the appeal to the Court of Appeals, including the court itself, recognized that Harris, Upham was a controlling person of Northcott prior to the termination of his employment, and all recognized at least implicitly, liability of the brokerage firm for his activities during that time. See opinion, appendix p. 11a. The Court of Appeals said that control ended when his employment ended, but a brokerage firm that permits, and furnishes facilities for, illegal sales of unregistered securities by its representative during his employment with it ought not to be able to escape liability under Section 15 for his continued illegal sales to its knowledge after termination of his employment by pressuring him to resign, by falsely representing to its regulatory agent that he had not been engaged in such sales and then taking no steps of its own to prevent such continued sales when it had the legal means to do so. The writ should be granted.

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# APPENDIX

# United States Court of Appeals

FOR THE FOURTH CIRCUIT

**No. 77-2051**

THOMAS S. CARPENTER and ELLIOTT TAYLOR,
*Appellants,*

vs.

HARRIS, UPHAM & COMPANY, INC.,
*Appellee.*

**No. 77-2052**

JOSEPH WARREN, III, MARK B. EDWARDS,
and EDWARDS & WARREN, PROFESSIONAL ASSOCIATION,
*Appellants,*

vs.

HARRIS-UPHAM AND COMPANY,
*Appellee.*

**No. 77-2181**

ELDO GROGAN, WILLIAM MILLS, AND GENE PATTON,
*Appellants,*

vs.

HARRIS, UPHAM & COMPANY, INC.,
*Appellee.*

**No. 77-2182**

MICHAEL B. ALLRAN, EDWARD R. ANDERSON,
A. J. BEALL, JR., ANNE C. HAWLEY,
BARBARA MORGAN, ROBERT S. MORGAN,
G. F. PARKER, SAMUEL WHITE,
R. W. CANNON, DOMINIC CAPELLI,

PAULINE CAPELLI, FRANK W. CAYCE,
JOHN GAYLORD, JR., JOHN A. JENKS,
FRANK MANSHIP,
*Appellants,*

v.

HARRIS, UPHAM & COMPANY, INC.,
*Appellee.*

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**Appeals from the United States District Court for the Western District of North Carolina, at Charlotte. James B. McMillan, District Judge.**

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Argued June 5, 1978 Decided March 13, 1979

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Before WIDENER and HALL, Circuit Judges, and HOFFMAN,* Senior District Judge.

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**Harry C. Hewson (Jones, Hewson & Woolard on brief) for Appellants in No. 77-2051; William G. Underwood, Jr. (Caudle, Underwood & Kinsey on brief) for Appellants in No. 77-2052; J. Douglas Stewart (Telford, Steward & Stephens on brief) for Appellants in No. 77-2181; Robert G. McClure, Jr. (Long, McClure and Dodd on brief) for Appellants in No. 77-2182; James H. Abrams, Jr. (William K. Diehl, Jr., James, McElroy & Diehl on brief) for Appellee in Nos. 77-2051, 77-2052, 77-2181 and 77-2182.**

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HOFFMAN, District Judge:

These cases are appeals from summary judgment granted in favor of Harris, Upham & Company, Inc. (Harris, Upham), a securities brokerage firm. The appellants sought to hold Harris, Upham liable for losses appellants incurred as purchasers of unregistered securities. The scheme involved investment in cattle and grain contracts purchased from companies operated by Wallace McKinney, a Kansas rancher. A

* Senior United States District Judge for the Eastern District of Virginia, sitting by designation.



central figure in the sale of the contracts was Gresham Northcott, a commodities broker employed by Harris, Upham's Charlotte, North Carolina, office until February 1, 1974. The losses which appellants sought to recoup were suffered on contracts purchased *after* Northcott left the employ of Harris, Upham. Appellants attempted to establish that the brokerage firm was a "controlling person" under Section 15 of the Securities Act of 1933 (15 U.S.C. § 77 (1 and 0)) and/or Section 20 of the Securities Exchange Act of 1934, (15 U.S.C. § 78 (j and t)). Following extensive discovery, the district court granted summary judgment, holding that there was no theory which would support a judgment against Harris, Upham based on actions taken by Northcott after he left the firm's employ.[1] We affirm.

[1] The order granting summary judgment contains no formal opinion. The only pertinent statement is as follows:

> I know of no theory that can support a judgment against Harris, Upham based on actions taken by Gresham Northcott after he left Harris, Upham's employ. Plaintiffs contend that Harris, Upham could have made a report to the New York Stock Exchange which may have resulted in the Stock Exchange's calling Northcott to the attention of the Securities & Exchange Commission which might have been able to stop Northcott before he injured plaintiffs. This tenuous chain is not sufficient to place Harris, Upham within the definition of a seller (or aider and abetter) or a controlling person as those terms are used in the relevant portions of the 1933 or 1934 Securities Acts.

The foregoing order was entered on April 20, 1977. On May 13, 1977, a final judgment of dismissal of the claims on which summary judgment was granted was entered in accordance with Rule 54(b) of the Federal Rules of Civil Procedure.

As to No. 77-2052 in which both Edwards and Warren, et al, and Harris, Upham were defendants, the motion for summary judgment filed by Harris, Upham is to the cross-claim for indemnity and contribution filed by Edwards and Warren, et al.

Several original plaintiffs did not appeal. It should also be noted that, in addition to Harris, Upham, there were many other defendants but the record does not disclose the disposition of the cases as to the defendants.

Many actions arose from losses suffered from investment in the McKinney operation and were consolidated for trial. Appellants (plaintiffs below) in Nos. 77-2051, 77-2181 and 77-2182 were purchasers of cattle or grain contracts. Appellants in No. 77-2052 (defendants and third-party plaintiffs below) sought indemnity and contribution from Harris, Upham for any liability which they or their law firm might suffer as a result of Northcott's actions. Since we hold that Harris, Upham could not have been liable as a controlling person under the facts of this case, summary judgment is affirmed as to all appellants.

The McKinney Cattle Company was engaged in feeding cattle prior to selling them to packing houses. In 1972 Northcott, while employed as a commodities broker for Harris, Upham, met McKinney in Kansas and solicited commodities business from him. McKinney became a customer of Harris, Upham, with Northcott as his registered representative.[2] Sometime in late summer or early fall of 1972, McKinney and Northcott began feeding cattle by means of subchapter-S corporations.[3] Three such corporations were formed. Those persons who became shareholders in these three corporations invested no cash, but instead filed financial statements with a Kansas bank showing a net worth of sufficient amount to allow the bank to loan the money which funded the corporations. Investors hoped to receive an immediate personal income tax deduction for the value of the grain purchased to feed the cattle, and anticipated converting ordinary income into capital gains upon liquidating the corporations within two years. Claude L. Ives, Jr., office manager for the Harris, Upham office in Charlotte, became a shareholder in one of the subchapter S corporations, along with Northcott. There is no evidence that this was ever more than a private investment for Ives, or that he

[2] At the time McKinney opened his account, Harris, Upham investigated McKinney by checking with the Hutchison National Bank and Trust Company in Hutchinson, Kansas, and determined that he was a man of substance who was in fact a legitimate cattle trader who hedged his own cattle.

[3] 26 U.S.C. § 1371, *et seq.*



ever recommended similar investments to Harris, Upham customers or anyone else.

In 1973 McKinney began to offer other modes of investment in cattle feeding. Investors began purchasing cattle on an oral basis from McKinney. Later in 1973 such purchases were transacted in the form of letter agreements. Finally, McKinney began using form contracts which had been revised by the lawyer defendants involved in this appeal. All of the above transactions were represented to be purchases of specific lots of cattle, ostensibly avoiding the registration requirements of the securities laws. Each contract would provide for the purchase of a given number of cattle, which were represented to have been presold to the packing houses at a prearranged price. Each investor's profit on the transaction was thus "guaranteed". However, by the spring of 1974 the basic plan had changed from one where McKinney actually held cattle for feeding to one where he attempted to cover contracts by buying and selling on the commodities market. New investor money was used to pay off existing investor contracts which had become due during the summer of 1974. This variation of the "Ponzi" scheme collapsed under its own weight in December, 1974, when McKinney was no longer able to pay contracts as they became due. According to McKinney's deposition, investors were never informed of the change in operation.[4] Investors discovered in November or December, 1974, that McKinney did not have enough cattle to meet the requirements of the outstanding contracts.

In February, 1973, Ives had noticed that margin calls had been made on hedging accounts for some of Harris, Upham's customers. He inquired of Northcott if those people were buying cattle from McKinney. Northcott admitted that he had referred to McKinney any customers who inquired about buying cattle, but stated that he was not receiving any compensation for such referrals. Ives testified in his deposition that he directed Northcott to stop making such referrals; Northcott

[4] Appendix p. 726-28.

denied that he was ever given such instructions. In a large part appellants' suits are based on Northcott's allegations that Ives must have been aware that Northcott was continuing to refer individuals to McKinney because of Northcott's activities in the office and because of correspondence which Northcott received at the office.[5] However, Northcott admitted that he never discussed the referrals with Ives, that he never showed the contracts to anyone at Harris, Upham, and that he never sought an opinion from Ives or the compliance department regarding the legality of the contracts.[6] Only one piece of correspondence was received by Northcott at the office prior to November, 1973.[7]

During 1973 Northcott was out of the office quite often and his production as a commodities broker declined sharply. When Ives brought this to his attention, Northcott attributed the decline to unfavorable conditions in the commodities market, and stated that he was attempting to obtain new accounts. It is now apparent that Northcott had begun to devote a large portion of his efforts to soliciting investors for McKinney. In early December Ives learned from a chance comment by a customer that Northcott had recommended that the customer consider investing in cattle. Ives immediately confronted Northcott, learned that he was still referring people to McKinney, and ordered him to stop making such referrals and to produce a list of those whom he had already introduced to McKinney. Ives then wrote to Robert Q. Jones, a vice president of Harris, Upham and Ives' immediate superior, and stated that he intended to terminate Northcott because of his poor production and because his outside activities were interfering with his performance as a broker. At Northcott's request, Jones, Ives and Northcott met to discuss the matter. Northcott again stated that he had merely introduced people to McKinney, that he had received no commissions from the

[5] Correspondence received by registered representatives at their offices of employment is opened by their employers for the purpose of supervising their activities pursuant to stock exchange rules.

[6] Appendix p. 776-84.

[7] See Appendix p. 501-02.



referrals, and that he had made it clear to the people he referred that Harris, Upham had nothing to do with the cattle feeding program.[8] Northcott agreed to produce a list of those whom he had referred to McKinney.

Two weeks later, on January 17, 1974, Northcott returned to the Harris, Upham office and voluntarily submitted his resignation effective February 1, 1974. He parted on generally amicable terms. When asked by Ives if he had prepared a list of referrals, Northcott stated the information was not available.[9]

On January 21, after receipt of Northcott's letter of resignation, Jones wrote to Ronald Veith, compliance director for Harris, Upham. Included in the letter was a summary of what Jones had learned from Ives and Northcott concerning the reasons for Northcott's termination. Based on the information in Jones' letter, Veith recommended that Northcott be given a clean release. Thereafter an RE-4 form was submitted to the New York Stock Exchange which contained no negative comments concerning Northcott.[10]

Following Northcott's termination, Harris, Upham personnel had very little contact with Northcott or McKinney. Early in 1974 one broker at the Harris, Upham office received several checks from BeTex Corporation, the entity through which Northcott began operating upon leaving the brokerage firm. The checks allegedly represented finders' fees which the broker split with Northcott, but do not involve any of the appellants in this case. McKinney continued to maintain a commodities account at Harris, Upham. In October, 1974, Ives received the proceeds from the liquidation of the subchapter-S corporation in which he had invested. Incidentally, Ives was replaced as office nanager by Cantwell on January 15, 1974.[11] Ives, however, retained his employment.

[8] Appendix p. 785.

[9] Appendix p. 495-97; Appendix p. 544.

[10] Appendix p. 744.

[11] Appendix p. 529.

It is pertinent to note the relationship of the litigants to Harris, Upham & Company. Of the twenty plaintiff-appellants before this court, only three maintained what may be termed active accounts at Harris, Upham. Three or four others had either inactive accounts or had at one time conducted an isolated trade through the firm. The remaining individuals had no contract whatsoever with Harris, Upham. *All of the contracts involved in this suit were executed after Northcott left the firm.* Appellants argue that all contracts were part of a series of transactions. However, nine of the appellants herein did not purchase their *first* contract until after Northcott's termination. Most of the appellants were not directly solicited by Northcott, but instead learned of the investment opportunity from three of the appellants who had been solicited by Northcott.

We have traced the development of the cattle feeding operation in some detail. The investment program in grain contracts, involving corn and milo leaseholds, was not created until at least March of 1974. We note at the outset that there is no evidence that Harris, Upham had any knowledge whatsoever that Northcott was planning to recommend investments in *grain contracts* while he was an employee of the firm.[12] Harris, Upham's control over Northcott, as well as any duty to supervise his future activities, terminated upon his separation from the firm. Summary judgment as to all claims based on grain contracts is therefore affirmed without further discussion.

Liability as a controlling person for acts committed by persons in one's control is found in both the 1933 Act and the 1934 Act. Section 15 of the 1933 Act, as amended, 15 U.S.C. § 77o, provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock

[12] Appendix p. 769.



> ownership, agency, or otherwise, controls any person liable under sections 77k or 771 of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Section 20 of the 1934 Act, 15 U.S.C. § 78t(a), similarly provides in part:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Noteworthy in each provision in the inclusion of a defense from liability based on "good faith" or lack of knowledge or reasonable belief. When originally passed by Congress, § 15 of the 1933 Act held controlling persons absolutely liable for § 11 and § 12 violations by controlled persons.[13] Congress, in passing the 1934 Act, amended § 15 of the earlier Act, adding the language beginning at "unless the controlling person had no knowledge of or reasonable ground to believe in the existence

[13] Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable.

1933 Act, ch. 38, § 15, 48 Stat. 84.

of facts by reason of which the liability of the controlled person is alleged to exist." Likewise, the controlling person provision in the new Act, § 20(a), contained the "good faith" defense to liability. Clearly Congress had rejected an insurer's liability standard for controlling persons in favor of a fiduciary standard—a duty to take due care. *Securities and Exchange Commission* v. *Lum's, Inc.,* 365 F.Supp. 1046, 1063 (S.D.N.Y. 1973); see Annot. 32 A.L.R. Fed. 714, 719. The intent of Congress reflected a desire to impose liability only on those who fall within its definition of control and who are in some meaningful sense culpable participants in the acts perpetrated by the controlled person. *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1299 (2nd Cir. 1973). The Supreme Court has noted that in each instance where Congress has created express civil liability in favor of purchasers or sellers of securities, it has clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 207-209 (1976). The controlling persons provisions contain a state-of-mind condition that requires a showing of something more than negligence to establish liability. *Id.* at n. 27-28.

The most obvious manner in which to establish liability as a controlling person is to prove that a person acted under the direction of the controlling person. This most commonly occurs in an employer-employee relationship. The lack of such a relationship is not determinative, however. *Hawkins* v. *Merrill Lynch, Pierce, Fenner & Beane,* 85 F. Supp. 104 (W.D. Ark. 1949). In order to satisfy the requirement of good faith it is necessary for the controlling person to show that some precautionary measures were taken to prevent an injury caused by an employee. *Securities & Exchange Commission* v. *First Securities Company of Chicago,* 463 F.2d 981, 987 (7th Cir. 1972); *Hecht* v. *Harris, Upham & Co.,* 430 F.2d 1202, 1210 (9th Cir. 1970). *See also, Zweig* v. *Hearst Corporation,* 521 F.2d 1129, 1134-35 (9th Cir. 1975).



The primary duty owned by a broker-dealer to the public is to supervise its employees in an adequate and reasonable fashion. While the standards of supervision may be stringent, this does not create absolute liability for every violation of the securities laws committed by a supervised individual. *SEC* v. *Lum's, Inc.,* 365 F.Supp. at 1064. It is required of the controlling person only that he maintain an adequate system of internal control, and that he maintain the system in a diligent manner. *Hecht* v. *Harris, Upham & Co.,* 430 F. 2d at 1210.

There is no evidence in this case that Northcott was acting at the direction of Harris, Upham at any time that he referred persons to McKinney. What evidence there is indicates very strongly that he was told *not* to make such references. Northcott never showed the cattle contracts to anyone at Harris, Upham, he never discussed them with his superiors, and he admitted that he was not hired to obtain purchasers for such investments. Thus there is no evidence that Harris, Upham exercised direct or indirect control over Northcott's activities with McKinney. The only possible theory of recovery for these appellants would require them to allege facts which, if proved, would establish that Harris, Upham failed to adequately supervise Northcott's dealings while he was employed by the firm. The only possible theory of recovery for these appellants would require them to allege facts which, if proved, would establish that Harris, Upham failed to adequately supervise Northcott's dealings while he was employed by the firm.

We find no facts in the record which would support the allegation that Harris, Upham was negligent in its supervision of Northcott. The firm properly opened Northcott's incoming mail. Viewed without benefit of hindsight, the correspondence introduced into the record does not indicate any wrong doing on Northcott's part concerning possible securities violations. Northcott's initial explanation that his loss of production was due to the commodities market was plausible. His decision to resign voluntarily in order to go into business for himself was

reasonable in light of his continuing low production. The firm was careful to ascertain that Northcott was not obtaining commissions for his referrals to McKinney, and Northcott denies that he obtained such commissions prior to January, 1974.[14]

We reiterate that there is no evidence that Harris, Upham was aware that the McKinney operation entailed possible securities violations. Without facts indicating such knowledge on the part of the firm, there is no evidence of "something more than negligence" on the part of Harris, Upham. *Ernst & Ernst* v. *Hochfelder, supra,* at n. 28.

Appellants have emphasized the failure of Harris, Upham to submit a more complete RE-4 form entitled "Notice of Discontinuance of Registered Employee" dated February 1, 1974, the same date that Northcott's resignation became effective. They argue that the negative answers given to question 8 prompted the continuation of Northcott as a registered representative when, had an investigation been conducted, Northcott would have been deprived of his privileges as a registered representative and the losses in dispute might not have occurred. We agree with the district court who described the situation as a "tenuous chain." As far as Harris, Upham is concerned, the record merely discloses knowledge of referrals of appellee's customers or other persons to McKinney. Perhaps a thorough investigation would have revealed more, but Harris, Upham, at least in December 1973, and perhaps as early as February 1973, directed Northcott to stop making these referrals. At best, Harris, Upham was guilty of simple negligence which, as heretofore stated, is not sufficient to establish liability. Under no circumstances was the RE-4 form a false statement in fact.

It is difficult to consider a complex case of multi-party litigation on appeal from summary judgment without the benefit of an opinion of the trial court, particularly when the

[14] Appendix p. 479; Appendix p. 542-43.



good faith of one of the parties is at issue. After reading over five thousand pages of depositions taken during the extensive pretrial discovery in this case, this court can say with conviction that a *prima facie* case of bad faith on the part of Harris, Upham has not been sufficiently alleged. We note with approval the opinion of Judge Ward in *Parsons* v. *Hornblower & Weeks-Hemphill, Noyes,* 447 F.Supp. 482 (M.D.N.C. 1977), *aff'd per curiam,* 571 F.2d 203 (4th Cir. 1978), which granted a motion for summary judgment in a complex securities case:

> The Court fully realizes that summary judgment is not a device to dispose of factual disputes. However, if a motion for summary judgment reveals that there is no genuine issue as to any material fact, then summary judgment is appropriate even in cases that, at first blush, appear to involve complex factual and legal issues. *See First National Bank* v. *Cities Service Co.,* 391 U.S. 253, 88 S.Ct. 1575, 20 L.Ed.2d 569 (1968).

The United States Court of Appeals for the Fourth Circuit has described the function of summary judgment as follows:

> [T]he function of a motion for summary judgment is to smoke out if there is any case, i.e., any genuine dispute as to any material fact, and, if there is no case, to conserve judicial time and energy by avoiding an unnecessary trial and by providing a speedy and efficient summary disposition. *Bland* v. *Norfolk & Southern Ry. Co.,* 406 F.2d 863, 866 (4th Cir. 1969).

The briefs, affidavits, and other materials filed by the parties in connection with the present motions have served this function.
447 F.Supp. at 487.

This court is of the opinion that summary judgment is appropriate in this case.

Appellants in No. 77-2182, Allran, et al, have alleged as an alternative theory of recovery that Harris, Upham is primarily liable for their losses, and that the firm is liable as an aider and abettor or under a conspiracy theory. For the reasons stated above, there are no facts to support any of those theories of recovery.

The lawyer-appellants seek contribution or indemnification from Harris-Upham. Since we affirm summary judgment as to all claims, there is no ground on which to hold the firm liable as a joint tortfeasor. Summary judgment is therefore affirmed as to the lawyer-appellants' claims.

AFFIRMED.



## STATUTES

**Section 2, 1933 Act**

§ 77b. Definitions

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any * * * investment contract * * *

**Section 5, 1933 Act**

§ 77e. Prohibitions relating to interstate commerce and the mails

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose

of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under Section 77h of this title.

**Section 12, 1933 Act**

§ 771. Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or ommission,



shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

**Section 13, 1933 Act**

§ 77m. Limitation of actions

No action shall be maintained to enforce any liability created under section 77k or 771(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 771(1) of this title, unless brought within one year after the violation upon which it is based. In no event shall any any such action be brought to enforce a liability created under section 77k or 771(1) of this title more than three years after the security was bona fide offered to the public, or under section 771(2) of this title more than three years after the sale.

**Section 15, 1933 Act**

§ 77o. Liability of controlling persons

Every person who by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 771 of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled persons is alleged to exist.

**Section 19, 1933 Act**

§ 77s. Special powers of Commission

(a) The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this subchapter. * * *

(b) For the purpose of all investigations which, in the opinion of the Commission, are necessary and proper for the enforcement of this subchapter, any member of the Commission or any officer or officers designated by it are empowered to administer oaths and affirmations, subpena witnesses, take evidence, and require the production of any books, papers, or other documents which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of such documentary evidence may be required from any place in the United States or any Territory at any designated place of hearing.

**Section 20, 1933 Act**

§ 77t. Injunctions and prosecution of offenses

(a) Whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, have been or are about to be violated, it may, in its discretion, either require or permit such person to file with it a statement in writing, under oath, or otherwise, as to all the facts and circumstances concerning the subject matter which it believes to be in the public interest to investigate, and may investigate such facts.

(b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions



of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter. Any such criminal proceeding may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such prospectus or security is received.

(c) Upon application of the Commission the district courts of the United States and the United States courts of any Territory, shall also have jurisdiction to issue writs or mandamus commanding any person to comply with the provisions of this subchapter or any order of the Commission made in pursuance thereof.

**Section 22, 1933 Act**

§ 77v. Jurisdiction of offenses and suits

(a) The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of any suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. * * *

**Section 2, 1934 Act**

§ 78b. Necessity for regulation

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regu-

lation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions: * * *

**Section 3, 1934 Act**

§ 78c. Definitions and application—Definitions

(a) When used in this chapter, unless the context otherwise requires—

(1) The term "exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

* * *

(3) The term "member" when used with respect to an exchange means any person who is permitted either to effect transactions on the exchange without the services of another person acting as broker, or to make use of the facilities of an exchange for transactions thereon without payment of a commission or fee or with the payment of a commission or fee which is less than that charged the general public, and includes any firm transacting a business as broker or dealer of which a member is a partner, and any partner of any such firm.



(4) The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

* * *

(10) The term "security" means any * * * investment contract, * * *

**Section 4, 1934 Act**

§ 78d. Securities and Exchange Commission

(a) There is hereby established a Securities and Exchange Commission (hereinafter referred to as the "Commission") to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate. * * *

(b) The Commission is authorized to appoint such officers, attorneys, examiners, and other experts as may be necessary for carrying out its functions under this chapter, * * *

**Section 5, 1934 Act**

§ 78e. Transactions on unregistered exchanges

It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction unless such exchange (1) is registered as a national securities exchange under section 78f of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

**Section 6, 1934 Act**

§ 78f. Registration of national securities exchanges

(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such date as to its organization, rules or procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be



considered conduct or proceeding inconsistent with just and equitable principles of trade.

(c) Nothing in this chapter shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this chapter and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this chapter and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

**Section 15, 1934 Act**

§ 78o. Over-the-counter markets; registration of brokers; information and reports

(a) (1) No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or

of any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.

* * *

(b) (1) A broker or dealer may be registered for the purposes of this section by filing with the Commission an application for registration, which shall contain such information in such detail as to such broker or dealer and any persons associated with such broker or dealer as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine.

* * *

(5) The Commission shall, after appropriate notice and opportunity for hearing, by order censure, deny registration to, suspend for a period not exceeding twelve months, or revoke the registration of, any broker or dealer if it finds that such censure, denial, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

* * *

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company,



bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(D) has willfully violated any provision of the Securities Act of 1933, or of the Investment Advisers Act of 1940, or of the Investment Company Act of 1940, or of this chapter, or of any rule or regulation under any such statutes.

* * *

**Section 15A, 1934 Act**

§ 78o-3. Over-the-counter brokers' and dealers' associations; registration—Association registration; national or affiliated; data

(a) Any association of brokers or dealers may be registered with the Commission as a national securities association pursuant to subsection (b) of this section, or as an affiliated securities association pursuant to subsection (d) of this section, under the terms and conditions hereinafter provided in this section, by filing with the Commission a registration statement in such form as the Commission may prescribe, setting forth the information, and accompanied by the documents, below specified:

(1) Such data as to its organization, membership, and rules of procedure, and such other information as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors; and

(2) Copies of its constitution, charter, or articles of incorporation or association, with all amendments thereto, and of its existing bylaws, and of any rules or instruments corresponding to the foregoing, whatever the name, hereinafter in this chapter collectively referred to as the "rules of the association."

* * *

Prerequisites to national registration; association rules

(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that—

* * *

(2) such association is so organized and is of such a character as to be able to comply with the provisions of this chapter and the rules and regulations thereunder, and to carry out the purposes of this section.

* * *

(8) the rules of the association are designed * * * in general, to protect investors and the public interest, * * *

(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules.

* * *

(12) the rules of the association include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be disseminated by any member or any person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations and to promote orderly procedures for collecting and publishing quotations.

* * *



**Section 21, 1934 Act**

§ 78u. Investigations; injunctions and prosecution of offenses

(a) The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this chapter or any rule or regulation thereunder, and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of the provisions of this chapter, in the prescribing of rules and regulations thereunder, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this chapter relates.

(b) For the purpose of any such investigation, or any other proceeding under this chapter, any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the United States or any State at any designated place of hearing.

(c) In case of contumacy by, or refusal to obey a subpena issued to, any person, the Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, and other records. And such court may issue an order requiring such person to appear before the Commission or member or officer designated by the

Commission, there to produce records, if so ordered, or to give testimony touching the matter under investigation or in question; and any failure to obey such order of the court may be punished by such court as a contempt thereof. All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found. Any person who shall, without just cause, fail or refuse to attend and testify or to answer any lawful inquiry or to produce books, papers, correspondence, memoranda, and other records, if in his power so to do, is obedience to the subpena of the Commission, shall be guilty of a misdemeanor and, upon conviction, shall be subject to a fine of not more than $1,000 or to imprisonment for a term of not more than one year, or both.

(d) Repealed. Pub.L. 91-452, Title II, § 212, Oct. 15, 1970, 84 Stat. 929.

(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

(f) Upon application of the Commission the district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States, shall also have jurisdiction to issue writs of mandamus commanding any person to comply with the provisions of this chapter or any order of the Commission made in pursuance thereof or with any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title.



## RULES OF NEW YORK STOCK EXCHANGE

Rule 342. "(a) Each office, department or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility.

"The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.

"(b) The general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities' laws and regulations. This person shall:

"(1) delegate to qualified principals, or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control.

"(2) establish a separate system of followup and review to determine that the delegated authority and responsibility is being properly exercised.

* * *

"Supplementary Material (Rule 342):

* * *

".16 Supervision of registered representatives. *** Duties of supervisors of registered representatives should ordinarily include at least *** review of correspondence of registered representatives, transactions, and customer accounts. ***

Rule 345. "(a) No member or member organization shall

"(1) permit any person to perform regularly the duties customarily performed by a registered representative, unless such person shall have been registered with and is acceptable to the Exchange, or

"(2) employ any registered representative or other person in a nominal position because of the business obtained by such person. ***

"(c) The Exchange may disapprove the employment of any person.

"(d)(1) If the Exchange determines that any employee or prospective employee of a member or member organization (aa) has violated any provision of the Constitution or of any rule adopted by the Board of Directors, (bb) has violated any of his agreements with the Exchange, (cc) has made any misstatement to the Exchange, or (dd) has been guilty of (i) conduct inconsistent with just and equitable principles of trade, (ii) acts detrimental to the interest or welfare of the Exchange, or (iii) conduct contrary to an established practice of the Exchange, the Exchange may withhold, suspend or bar such person from employment by a member or member organization; may fine such employee or prospective employee $5,000 for each such violation, misstatement, or act or omission for which he has been found guilty; and may direct that he be censured. The Exchange shall disclose publicly bars or suspensions of employees and former employees. The Exchange may in its discretion, disclose publicly censures and fines which may be imposed upon any employee or prospective employee at any one time shall not exceed $25,000.

* * *

"Supplementary Material (Rule 345):

* * *



".13 Termination of employment.—The discharge or termination of employment of any registered representative or officer, together with the reasons therefor, shall be reported promptly to the Department of Member Firms on a RE-4 Form which forms are available at the Mailing Division of the Exchange.

* * *

".17 Agreements.—Each prospective registered representative or officer shall sign the following statements:

"(a) 'I authorize and request any and all of my former employers and any other person to furnish to the Exchange, or any agent acting on its behalf, any information they may have concerning my credit worthiness, character, ability, business activities, general reputation, mode of living and personal characteristics, together with, in the case of former employers, a history of my employment by them and the reasons for the termination thereof. Moreover, I hereby release each such employer and each such other person from any and all liability of whatsoever nature by reason of furnishing such information to the Exchange or any agent acting on its behalf.

* * *

"Further, each registered representative, in consideration of the Exchange's approving his application, shall sign the following statements:

* * *

"(H) I agree that I will not take, accept, or receive, directly or indirectly, from any person, firm corporation or association, other than my employer, compensation of any nature, as a bonus, commission, fee, gratuity or other consideration, in connection with any securities, commodities or insurance transaction or transactions, except with the prior written consent of the Exchange.

* * *

"(K) If the Exchange, during the period of 90 days immediately following receipt by the Exchange of written notice of the termination of my employment gives me written notice that the Exchange is making inquiry into any specified matter or matters occurring prior to termination of such employment, I agree that I will thereafter, comply with any request of the Exchange for me to appear and testify, submit records, respond to written requests, attend hearings, and accept disciplinary charges or penalties with respect to the matter or matters specified in such notice in every respect in conformance with the Constitution, Rules and practices of the Exchange in the same manner and to the same extent as required to do if I had remained an employee. If I refuse to accept such written notice or, having been given such notice, refuse or fail to comply with any such request of the Exchange, I agree that such refusal or failure may, in the discretion of the Exchange, act as a bar to future Exchange approval of my employment until such time as the Exchange has completed investigation into the matter or matters specified in such notice; has determined a penalty, if any, to be imposed against me; and until the penalty, if any, has been carried out.

* * *

Rule 346. "Every registered representative or officer of a member or member organization shall devote his entire time during business hours to the business of the member or member organization employing him, and shall not at any time be engaged in any other business or be employed by any other corporation, firm or individual, or serve as an officer or director of another corporation, or own any stock, or have, directly or indirectly, any financial interest in any other member organization or any non-member organization engaged in any securities, financial or kindred business without the prior written approval of the Exchange, or except as otherwise permitted by the Rules of the Board of Governors.

* * *



Rule 350. "(a) No member, allied member, member organization or employee thereof shall:

"(1) employ or compensate for services rendered, except as specified below or with the prior written consent of the employer and the Exchange, or

"(2) give any gratuity in excess of $25 per person per year to any principal officer, or employee of the Exchange or its subsidiaries, another member or member organization, financial institution, news or financial information media, or non-member broker or dealer in securities, commodities, or money instruments.

"A gift of any kind is considered a gratuity.

* * *

Rule 351. "Whenever any employee of a member or member organization who is registered with the Exchange, has ever been or becomes the subject of:

"a) through g) * * *

"h) any material allegation that he has conducted himself in a way which may be inconsistent with just and equitable principles of trade, or detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange; or whenever any such registered employee has violated or violates any provision of the Constitution or of any Rule adopted by the Board of Governors or of any securities or insurance law or regulation or of any agreement with the Exchange, such employee shall promptly notify his employer thereof."

"Whenever a member or member organization has knowledge that any of his or its registered employees is required to give the notice required hereby, such member or member organization and such employee shall promptly notify the Exchange of such matter."

Rule 405. "Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) Sec. 2342 to

"(1) Use due diligence to learn the essential facts relative to every customer * * *



STATE OF KANSAS 77-2051

## AGREEMENT

COUNTY OF RENO

THIS AGREEMENT made and entered into this 17 day of May, 1974, by and between Thomas S. Carpenter of Box 1473, Charlotte, North Carolina 28232, hereinafter referred to as "Owner," and MCKINNEY CATTLE CO., 27 Washington Center, Hutchinson, Kansas 67501, hereinafter referred to as "McKinney."

WITNESSETH:

WHEREAS, Owner desires to enter into an agreement with McKinney for the purchase and maintenance of 200 steers in order for Owner to obtain a profit from the fattening and sale of such steers

WHEREAS, McKinney will sell steers to Owner and retain such steers on land owned or leased by McKinney and will care for and fatten such steers and sell such steers for the profit of Owner:

WHEREAS, Owner realizes that McKinney can only guarantee his own profit if he is assured of supplies and costs of the feed utilized in the fattening of the steers of Owner; and

WHEREAS, Owner is willing to pay money in advance for the acquisition of the feed necessary to fatten his steers, so as to assure Owner's maximum cost for fattening his steers.

IT IS THEREFORE AGREED as follows:

1. *Amount of Investment.* Owner agrees to pay $30,000 to McKinney for the purchase, feed, maintenance and care of Owner's steers.

2. *Number of Steers.* McKinney agrees to purchase, feed, maintain and care of 200 steers for Owner.

3. *Finder's Fee.* Owner agrees to pay a finder's fee of $3.00 per steer for a total of $600 to BeTex Corporation, 320 S. Tryon Street, Suite 112, Charlotte, North Carolina 28201.

4. *Date of Payment.* Payment of the amounts set forth in paragraph 1 and the amount set forth in paragraph 3 shall be made to the respective payees on May 18, 1974.

5. *Weight and Price of Steers.* McKinney agrees that the steers it shall acquire shall weigh approximately 450 pounds and shall be purchased for a price of $.39 per pound.

6. *Weight Gain.* McKinney agrees that it shall cause 350 pounds of weight gain to be added to the steers belonging to Owner at a cost per pound not to exceed $.35.

7. *Selling Price of Steers.* McKinney agrees that at the time of acquisition of the steers for Owner, McKinney shall contract to sell such steers at a price of 44 cents per pound, and selling weight shall be acquisition weight set forth in paragraph 5 plus the guaranteed weight gain set forth in paragraph 6, which total is 800 pounds. The express responsibility for entering into such contract for sale shall be that of McKinney.

8. *Identification of Steers.* McKinney agrees that the steers belonging to Owner shall be placed upon grazing lands or in the feed yards of McKinney and shall be readily identifiable and available for inspection at all times by Owners.

9. *Insurance.* McKinney agrees that all steers of Owner shall be insured for full mortality, with a deductible limitation of $1,000 per pen (200 steers).

10. *Security Interest.* Owner agrees that McKinney shall be entitled to assign, mortgage or otherwise convey for security purposes the steers of Owner, such security interest is to be on notes providing additional funds for acquisition, feeding, care, or insuring the steers of Owner.



11. *Feed.* McKinney agrees to physically acquire and to immediately obtain all feed necessary for the fattening of steers belonging to Owner, said fee to be sufficient in quantity to increase the weight of steers of Owner by the amount of weight increase set forth in paragraph 6.

12. *Sales Proceeds.* McKinney shall remit the amounts received, less any loan balances, on account of the sale of the steers of Owner to Owner on or before Dec. 21, 1974.

13. *Additional Pen Space.* McKinney agrees to make available additional pen space to Owner for the continued feeding of cattle at the desire of Owner.

14. *State Law.* This agreement shall be deemed to have been made in the State of Kansas and shall be interpreted in accordance with the laws of said state.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals and have bound themselves, their heirs, their estates and their assigns, the day and year first written above.

THOMAS S. CARPENTER (SEAL)

WALLACE G. MCKINNEY (SEAL)

McKinney Cattle Co. by Wallace G. McKinney

MR. WALLACE G. MCKINNEY
McKinney Cattle Co.
27 Washington Center
Hutchinson, Kansas 67501

Dear Mr. McKinney:

Enclosed please find two copies of revised agreements involving Wayland H. Cato, Jr., Mark B. Edwards and Joseph Warren III, each agreement being with McKinney Cattle Co.

The figures included herein and the basic thrust of the language of the agreement are those presented to us by Mr. Gresham Northcott of Charlotte, North Carolina. I believe that he has subsequently been in contact with you and has indicated that Mr. Cato, Mr. Edwards and I were interested in acquiring 400 steers at the prices indicated.

The contract agreement is modified slightly from that which Mr. Northcott presented in order to buttress the position of the cattle owner under the terms of Revenue Ruling 73-530 (see copy of my letter addressed to Mr. H. H. Thomason dated November 14, 1973). The agreement was reviewed with Mr. Northcott prior to execution of same by the three parties listed above.

You will note that in each case paragraph 12 contains a blank. All of us are of the opinion that a date should be inserted herein for the purpose of requiring a final date for closing out payment on the sale of the steers. As you can imagine, we are anxious to make that date as early in 1974 as possible, but are not anxious to create unreasonable difficulties for you. In view of the fact that our previous experience has been that a turn-around period of approximately six months is all that is required, and since the contract is dated November 1, 1973, we anticipate that a date around June 1, 1974 should be sufficient time (seven months) for the completion of the transaction.

Accordingly, we could expect you to fill in line 12 and then return one signed copy of each contract to me. At that time, the $50,000 which is due McKinney Cattle Co. will be forwarded to you by return mail.



I have also enclosed one copy of a Power of Attorney for each of the three investors. It has been modified from the form in which it was submitted to me by Mr. Northcott so as to eliminate any individual executing such power from being made personally liable on or for actions undertaken by you or Mr. Shaft. We, of course, realize that tremendous latitude still exists within the Power of Attorney, but we do not believe that you intend for the power to encompass our being personally liable for any acts undertaken by either of the attorneys-in-fact.

One other matter which I have discussed with Mr. Northcott but which I believe must be adequately documented with you is our right to receive the necessary information for the filing of our Federal income tax returns. As part of your acceptance of the agreement, we consider it necessary to have you warrant to us that we will receive all necessary tax information by March 15, 1974. Should you be in need of the information, I have listed the social security numbers of the three investors at the bottom of this letter.

Although I have discussed all of these matters with Mr. Northcott, if I have created any unforseen problems for you, I would be happy to rectify them in whatever way I might. Please call me collect if any action needs to be taken. Our telephone number until December 1 is still (704) 334-9731.

Sincerely yours,

(SIGNED) JOSEPH WARREN III

Joseph Warren III

JW:pj:816

Enclosures

WAYLAND H. CATO, JR.—259-12-8601
MARK B. EDWARDS—238-54-4188
JOSEPH WARREN III—142-30-7065

cc: MR. GRESHAM NORTHCOTT
MR. WAYLAND H. CATO, JR.
MR. H. H. THOMASON
MR. MARK B. EDWARDS

77-2051

STATE OF KANSAS }
COUNTY OF RENO }

## AGREEMENT

THIS AGREEENT made and entered into this 1st day of November, 1973, by and between WAYLAND H. CATO, JR. of Charlotte, North Carolina, hereinafter referred to as "Owner," and McKINNEY CATTLE CO., 27 Washington Center, Hutchinson, Kansas 67501, hereinafter referred to as "McKinney."

WITNESSETH:

WHEREAS, Owner desires to enter into an agreement with McKinney for the purchase and maintenance of 300 steers in order for Owner to obtain a profit from the fattening and sale of such steers;

WHEREAS, McKinney will sell steers to Owner and retain such steers on land owned or leased by McKinney and will care for and fatten such steers and sell such steers for the profit of Owner;

WHEREAS, Owner realizes that McKinney has guaranteed a maximum cost to Owner for fattening the steers of Owner;

WHEREAS, Owner realizes that McKinney can only guarantee his own profit if he is assured of supplies and costs of the feed utilized in the fattening of the steers of Owner; and

WHEREAS, Owner is willing to pay money in advance for the acquisition of the feed necessary to fatten his steers, so as to assure Owner's maximum cost for fattening his steers.

IT IS THEREFORE AGREED as follows:

1. *Amount of Investment.* Owner agrees to pay $37,500.000 to McKinney for the purchase, feed, maintenance and care of Owner's steers.



2. *Number of Steers.* McKinney agrees to purchase, feed, maintain and care for 300 steers for Owner.

3. *Finder's Fee.* Owner agrees to pay a finder's fee of $2.00 per steer for a total of $600.000 to BeTex Corporation, Box 2374, Charlotte, North Carolina 28201.

4. *Date of Payment.* Payment of the amount set forth in paragraph 1 and the amount set forth in paragraph 3 shall be made to the respective payees on December 1, 1973.

5. *Weight and Price of Steers.* McKinney agrees that the steers it shall acquire shall weigh approximately 450 pounds and shall be purchased for a price of $60.00 per cwt.

6. *Weight Gain.* McKinney agrees that it shall cause 300 pounds of weight gain to be added to the steers belonging to Owner at a cost per pound not to exceed $0.37.

7. *Selling Price of Steers.* McKinney agrees that at the time of acquisition of the steers for Owner, McKinney shall contract to sell such steers at a price of 0.58 cents per pound, and the selling weight shall be acquisition weight set forth in paragraph 5 plus the guaranteed weight gain set forth in paragraph 6, which total is 750 pounds. The express responsibility for entering into such contract for sale shall be that of McKinney.

8. *Identification of Steers.* McKinney agrees that the steers belonging to Owner shall be placed upon grazing lands or in the feed yards of McKinney and shall be readily identifiable and available for inspection at all times by Owners.

9. *Insurance.* McKinney agrees that all steers of Owner shall be insured for full mortality, with a deductible limitation of $1,000 per pen (200 steers).

10. *Security Interest.* Owner agrees that McKinney shall be entitled to assign, mortgage or otherwise convey for security purposes the steers of Owner, such security interest to be on notes providing additional funds for acquisition, feeding, care, or insuring the steers of Owner.

11. *Feed.* McKinney agrees to physically acquire and to immediately obtain all feed necessary for the fattening of steers belonging to Owner, said fee to be sufficient in quantity to increase the weight of steers of Owner by the amount of weight increase set forth in paragraph 6.

12. *Sales Proceeds.* McKinney shall remit the amounts received, less any loan balances, on account of the sale of the steers of Owner to Owner on or before June 15, 1974.

13. *Additional Pen Space.* McKinney agrees to make available additional pen space to Owner for the continued feeding of cattle at the desire of Owner.

14. *State Law.* This agreement shall be deemed to have been made in the State of Kansas and shall be interpreted in accordance with the laws of said state.

IN WITNESS WHEREOF, the parties hereto have set their hands and seals and have bound themselves, their heirs, their estates and their assigns, the day and year first written above.

WAYLAND H. CATO, JR. (SEAL)

Wayland H. Cato, Jr.

WALLACE G. MCKINNEY (SEAL)

McKinney Cattle Co. by Wallace G. McKinney



New York Stock Exchange, Inc. 55 Water Street New York, N.Y. 10041

**NOTICE OF DISCONTINUANCE OF REGISTERED EMPLOYEE**

1. James G. Northcott Jr.

(Name of Employee)

2. Registered Representative

(Capacity)

3. Harris Upham & Co. Incorporated

(Name of Firm)

4. 100 N. Carolina Natl Bk. Charlotte, North Carolina

(Office of Employment)

5. 1610 Hertford Road, Charlotte, North Carolina

(Present Home Address)

6. Date of Discontinuance: Feb. 1, 1974

7. Reason for Discontinuance:

| | | |
|---|---|---|
| Voluntary resignation | XXX | |
| *Permitted to resign | | * |
| *Discharge | | * (Check One) |
| Decreased | | |
| *Other | | * |

If known, name of next employer _____

8. Within your knowledge and the records of your firm was he (she) *ever* subject of

| | YES | NO |
|---|---|---|
| (a) an investigation or proceeding by any governmental or securities industry regulatory body | | X |

| | YES | NO |
|---|---|---|
| (b) a refusal of registration censure, suspension, expulsion or other discipline by any governmental or securities industry regulatory body | ____ | X |
| (c) any major complaint by a customer of your firm | ____ | X |
| (d) any disciplinary action by your firm | ____ | X |
| or has he (she) ever | | |
| (e) violated any provision of the NYSE Constitution or Rules or of any securities law or regulation | ____ | X |
| (f) violated any of his (her) agreements with the Exchange | ____ | X |
| (g) conducted himself (herself) in a way which may be inconsistent with just and equitable principles of trade detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange. | ____ | X |
| Aside from the foregoing, do you know of any reason why the subject should not be employed by another member or member organization? | ____ | X |

*Give full details on the other side for any "yes" answer above or for any answer marked by an asterisk (*). If not practicable to embody information in this form, please communicate otherwise with the Department of Member Firms.*

Date: 2-1-74

ROBERT Q. JONES

Individual signature of Member,
General Partner or Voting Stockholder



**(77-2051)**

January 21, 1974

Mr. Ronald Veith
NEW YORK OFFICE

Dear Ron:

Please refer to the attached unsolicited letter of resignation from Gresham Northcott of our Charlotte office.

Mr. Ives, our Charlotte manager, advised me in December that he was considering termination of Northcott since he had been very unproductive in recent months and was not giving his best efforts to Harris, Upham.

During my visit in Charlotte on January 3rd and 4th Ives and I learned that Northcott had been pursuing some private business affairs in recent months. We advised Northcott to discontinue these activities and to advise us of their specific nature prior to our consideration of continuing his employment. Apparently Northcott had made certain arrangements to introduce various individuals to some cattle feed lot operators in Kansas. The purpose of these introductions was to enable these persons to buy cattle in the pens through the offices of the operator. Northcott advises us that he received no compensation for these introductions, nor did he profit in any indirect way from them, but that he anticipated the prospects of commodity futures business at some point in time. Any business so derived, however, was not to be contingent on these introductions.

Northcott further advised that he made it clear to the people involved that he was not acting as a representative of Harris, Upham. He states that some of the persons introduced were Harris, Upham customers and some were not.

We have received no complaints from anyone on these activities and do not believe that we will receive any. Our investigation is somewhat incomplete, but, on the basis of the facts presented I would appreciate your advice as to whether Northcott should be given a clean release from Harris, Upham.

Very truly yours,

Robert Q. Jones

RQJ/vmm

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1979

No. 79-120

THOMAS S. CARPENTER, ELLIOTT TAYLOR, ELDO GROGAN, WILLIAM MILLS, and GENE PATTON,

Petitioners,

v.

EDWARDS AND WARREN, PROFESSIONAL ASSOCIATION; MARK B. EDWARDS; JOSEPH WARREN, III; GRESHAM NORTHCOTT; BETEX CORPORATION, a North Carolina corporation; HARRIS, UPHAM & COMPANY, INC.; MICHAEL B. ALLRAN; EDWARD R. ANDERSON; A. J. BEALL, JR.; ANNE C. HAWLEY; BARBARA MORGAN; ROBERT S. MORGAN; G. F. PARKER; SAMUEL WHITE; R. W. CANNON; DOMINIC CAPELLI; PAULINE CAPELLI; FRANK W. CAYCE; JOHN GAYLORD, JR.; JOHN A. JENKS; and FRANK MANSHIP,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

# RESPONDENT'S BRIEF IN OPPOSITION

WILLIAM K. DIEHL, JR.
700 Home Federal Building
139 South Tryon Street
Charlotte, N.C. 28202
704/372-9870
Counsel for Respondent,
Harris, Upham & Company, Inc.

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## QUESTION PRESENTED

Was Harris Upham and Company, Inc. a controlling person, under §15 of the Securities Act of 1933 [77 U.S.C. 77(o)], of its former employee, Gresham Northcott, at the time Northcott participated in the sale of unregistered securities to Petitioners?

## STATEMENT OF THE CASE

The following additional facts do not appear in Petitioners' statement of case:

1. Of the five petitioners, only Carpenter has ever been a customer of Harris Upham. The remaining four had no contact at any time for any reason with Harris Upham. Taylor was introduced to Northcott through Carpenter. Carpenter was an experienced trader in securities and commodities. He was sophisticated in common stocks, had invested in oil and gas, had sold short, had sold short against the box, had bought and sold options and was familiar with straddles, puts and calls. He has maintained margin accounts at Harris Upham, Reynolds Securities and Merrill Lynch (losing $49,000 of a $50,000 investment in the latter account). Carpenter's contracts



upon which suit was filed are dated May and September, 1974. There is no evidence that Harris Upham knew of Carpenter's contracts. Taylor's contract is also dated September, 1974. Taylor, Grogan, Mills and Patton all concede that Harris Upham did not know they had any transactions with Northcott. Grogan sued on contracts entered in June and July of 1974. Mills and Patton signed their contracts in July of 1974 and their sole source of information concerning the contracts was their co-petitioner Grogan. Mills and Patton never even talked to Northcott before signing their contracts.

2. With respect to all contracts at issue on this petition, Harris Upham received no compensation of any kind on any transaction; no employee of Harris Upham knew prior to or at the time of the transaction of any of Petitioners' signing the contracts; no petitioner lost any money prior to Northcott's termination at Harris Upham; no petitioner thought they were dealing with Harris Upham regarding the contracts sued upon; the Petitioners were aware of the inherent risk in these invest-

ments which returned large profits (60%) in a very short time, three to six months; no petitioner ever delivered money to Harris Upham or received any transaction confirmation from Harris Upham regarding the contracts; no petitioner made any complaint to Harris Upham, until these lawsuits were filed; Harris Upham had absolutely nothing to do with any of Petitioners' contracts.

3. The present Petition has distilled Petitioners' earlier claims to the sole question of whether or not Harris Upham was a controlling person of their former employee three months, five months and seven months following his departure from the brokerage firm.

REASONS WHY THE WRIT SHOULD BE DENIED

The summary judgment procedure authorized by Rule 56 is a method for promptly disposing of actions in which there is no genuine issue as to any material fact or in which only a question of law is involved. 10 Wright & Miller, Fed. Prac. & Proc., Civil, §2712, p. 370 (1973),[numerous



cases cited.]

A review of the petition seeking a writ of certiorari in this case points to the obvious conclusion that Petitioners do not seriously contend factual issues abound which prevent entry of summary judgment. Rather, they argue that both the District Court and the United States Court of Appeals for the Fourth Circuit have misunderstood this Court's holding in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) and the statutory meaning of the word "control" as used in §15 of the Securities Act of 1933, 15 U.S.C. §77(o).

Petitioners point to no factual controversy to support the argument that material facts are in dispute. Both the District Court and the Court of Appeals examined better than 5,000 pages of pretrial discovery, exhibits approaching 1,000 in number and a plethora of briefs from parties to the litigation.

The District Court simply held that it knew of no theory which supported a judgment against Harris Upham based upon the actions taken by Gresham Northcott after he left the employ of Harris Upham.

The argument that Harris Upham could have made a report to the New York Stock Exchange which might have resulted in the Exchange calling Northcott before the S.E.C. which could have stopped Northcott before he injured Plaintiffs was described by Judge McMillan as "tenuous." He found that Harris Upham was not a "controlling person" as that term was used in the relevant portions of the 1933 Act. [District Court Order, Court of Appeals Appendix, page 737]

The Court of Appeals in affirming summary judgment stated "...Harris Upham could not have been liable as a controlling person under the facts of this case." 594 F.2d 388, 391 (1979). Following a petition for rehearing filed by these same Petitioners, neither the panel nor any judge of the Court thought further hearing would benefit that court or change the result. [Appendix to this Brief in Opposition]

Petitioners seek to impose liability upon a brokerage firm for the acts of its former employee, which acts took place three, five and seven months following the former employee's termination from the



firm. What the broker did before he left the firm, what Harris Upham did while he was with the firm, at his departure, and following his departure was not seriously contested by any of the parties. It is the legal question which stimulates the present Petition, i.e., do the facts support the imposition of "control" liability on this brokerage firm for conduct, actually unknown to the brokerage firm, which occurred after he was no longer employed by Harris Upham?

Respondent suggests that if Harris Upham had no "actual control" it is not liable. In the legislative history of the control sections, Congress explicitly stated that control was to be actual, as well as legally enforceable. See Burden of Control, 6 S.E.C. Law Review, 616 at 620 (1974). A quote from Ferland v. Orange Groves of Florida, Inc., 377 F. Supp. 690 (M.D.Fla., 1974) is illustrative. There, the Court speaking of the control section of both 1933 and 1934 Acts held:

> "...for purposes of attaching liability under either provision in a manner consistent with due process, the person sought to be held liable for the conduct of

> another must be shown to have had the lawful authority to control or influence the conduct in such a way as to have been able to avoid liability. Strong v. France, 474 F.2d 747 (9th Cir., 1973)."

See also Jackson v. Bache and Co., Inc., 381 F. Supp. 71 (N.D.Cal., 1974).

In Sennot v. Rodman & Renshaw, 474 F. 2d 32 (8th Cir.), cert. den. 414 U.S. 926 (1973), in construing the control section under the 1934 Act, the Eighth Circuit noted that the brokerage firm's duty to control its partners, agents as well as past employees extended only to transactions with or by these parties where the brokerage firm was itself involved. To extend it further"...would be to impose liability upon Rodman for virtually any act of its past or present employees or partners, regardless of how remote and unrelated that act might be to Rodman..."

The Securities and Exchange Commission defines control as follows:

> "The term 'control'...means the possession directly or indirectly of the power to direct or cause the direction of management and policies of a person, whether through the



> ownership of voting securities, by contract or otherwise. 17 C.F.R., §231.405(f)(1971)."

Petitioners do not point to a single authority where the "control" section of either the 1933 or 1934 Act has been extended to cover a situation in which a brokerage firm obtains liability for the acts of its former employees (or person otherwise associated with the firm) following termination of his employment or association with the firm. [Reading the opinions in Hawkins v. Merrill Lynch, 85 F. Supp. 104 (W.D.Ark., 1949), and Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880 (3rd Cir., 1975) makes clear that Petitioners' reliance on these cases is misplaced.]

Respondent does not contend that "control" is exclusively an employer-employee or respondeat-superior relationship. On the other hand, a consistent theme is revealed in prior cases dealing with the subject and in each instance, found by Respondent, where liability was imposed, the control of the brokerage firm or principal continued through the illegal act. Where there is a break or interruption in the

direction of the alleged controlling party over the miscreant, no control has been found. That is exactly the posture of the instant case. Northcott was terminated on February 1, 1974 and Harris Upham had absolutely nothing to do with him or anybody he dealt with after that date. The firm had no "control" over him or what he did after February 1, 1974 any more than his parents, school teachers or ministers when he left those respective superiors.

Petitioners argue that had Harris Upham filed a "bad report" with the New York Stock Exchange following Northcott's termination, then Petitioners, if 14 or 15 other events had occurred, would not have entered into any contracts with Northcott in May, July and September, 1974. The speculative and conjectural nature of this argument would seem apparent on its face. It is also true that if Northcott had been run over by a truck the day after he left Harris Upham, Petitioners might not have entered into contracts with him. The District Court described the "chain" as "tenuous." The Court of Appeals agreed. 594 F.2d 388, 395. As the Court of Appeals



observed, the fact that Harris Upham knew that Northcott was referring customers to McKinney in 1973 and a more thorough investigation, beyond their telling Northcott to stop such referrals, might have revealed more, does not impose control liability once Northcott is no longer with them.

It is perhaps charitable, at best, to recognize that the "RE-4" argument is a bootstrap attempt to impose liability under an implied cause of action against Harris Upham for purportedly violating the New York Stock Exchange Rules. This Court's recent opinions in Cort v. Ash, 422 U.S. 66 (175) and Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, rehr. den. 430 U.S. 976 (1977) and the lengthy opinion of Judge Friendly in Colonial Realty Corp. v. Bache and Co., 358 F.2d 178 (2nd Cir.) cert. den. 385 U.S. 817 (1966) compel the conclusion that no implied cause of action exists in this instance, even if the Court found that Harris Upham had breached a New York Stock Exchange rule. The nature of the reporting rule makes clear it was not designed for the general public but rather was designed for the benefit of members of the Exchange,

there is no specific jurisdictional grant in any statute to imply such a cause of action, the legislative intent was to professionalize the brokerage business and encourage ethical self-regulation and it is not necessary to imply a cause of action because there are state common law remedies.

Respondent further suggests that "what would have or might have" happened is basically immaterial. The cases on control demonstrate that there is no controlling person liability where the alleged controlling person receives no direct benefit from the illegal transaction, had no directional relationship with the wrongdoer at the time of the wrong, and does not even know of the particular transaction giving rise to liability. Harris Upham falls into that category and should not be subject to suit as the "deep pocket" or an insurer for Petitioners' losses.

Beyond the events surrounding Northcott's termination in January, 1974, effective February 1 of that year, Defendants offered no evidence of any conduct on the part of Harris Upham related to their individual purchase of cattle contracts through Northcott. It is almost incon-



ceivable to suggest that Harris Upham could somehow have knowledge or reasonable ground to believe in the existence of facts by reason of which the liability of Northcott was alleged to exist. That "due care" standard affords Harris Upham a complete defense even if it were a "controlling" person of Northcott. On the same record upon which the Court of Appeals found no control, they similarly found no factual controversy that Northcott had not been adequately supervised while with the firm and certainly he was not subject to supervision when he left the firm.

Whether the Court of Appeals for the Fourth Circuit has misinterpreted the language used by this Court in Hochfelder in distinguishing between theories of liability under the 1933 and 1934 Acts is not pertinent to the result in this case. Respondent concedes that there is support for the proposition that negligent conduct is a basis for liability under 15 U.S.C. §77(o), the control provisions subject of this appeal, based upon the express language in Hochfelder. It appears to Respondent that the reference to the controlling person

provision where the Fourth Circuit makes its statement regarding a state of mind condition requiring "a showing of something more than negligence to establish liability" was specifically directed to liability under the 1934 Act, which under the ruling in Hochfelder would require a showing of scienter, something Petitioners utterly failed to prove throughout this particular litigation. From the earlier paragraph on page 394 of the Fourth Circuit's Opinion, it is clear that they correctly observed that this Court has noted in each instance where Congress has created express civil liability, it has clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake. Petitioners fail to establish any showing of control or lack of due care, both ingredients for liability under §15 of the 1933 Act, making clear that the comment, even if erroneously applied to §15 is harmless. It is also clear that Judge Hoffman speaking for the Fourth Circuit was quoting directly from a footnote to this Court's opinion in Hochfelder which reads:



"28. Each of the provisions of the 1934 Act that expressly create civil liability, except those directed to specific classes of individuals such as directors, officers, or 10% beneficial holders of securities, see §16(b), 15 USC §78p(b) [15 USCS §78p(b)], Foremost-McKesson, Inc. v Provident Securities Co. 423 US 232, 46 L Ed 2d 464, 96 S Ct 508 (1976); Kern County Lane Do. v Occidental Petroleum Corp. 411 US 582, 36 L Ed 2d 503, 93 S Ct 1736 (1973), contains a state-of-mind condition requiring something more than negligence."

There is no doubt that he was speaking to the 1934 Act and thus the "scienter" requirement found to exist by this Court in Hochfelder.

## CONCLUSION

Because there was no genuine issue of any material fact, entry of summary judgment in these cases was proper. The result was fair and accurate and came after a significant amount of discovery which brought forward for the lower Courts' review all of the pertinent events which occurred. Beyond cavil, Harris Upham established that it had no actual or other

form of control of its former employee after February of 1974. That the employee dealt with these Petitioners, some three, five and seven months later in the sale of unregistered securities does not impose liability on Harris Upham. Beyond the fact that Mr. Northcott at one time worked with Harris Upham, Petitioners have not produced a scintilla of evidence that in May, July and September of 1974 Harris Upham had even the remotest form of contact with them, in connection with their purchase of securities through Northcott.

There is no establishment of "control" because Harris Upham purportedly filed a defective RE-4 form with the New York Stock Exchange.

Imposition of liability upon a brokerage firm upon the facts of this case would permit the Federal Courts to be inundated with security litigation against "deep pocket" brokerage firms for the activities of its former employees, who could or might have gotten their "bad start" by working with a member New York Stock Exchange firm. Such is not the intent of the Congress with regard to the



1933 and 1934 Acts nor should such theory be given judicial support by this Court. Harris Upham is simply not liable to these Petitioners and the Writ of Certiorari should be denied.

Respectfully submitted,

William K. Diehl, Jr.
James, McElroy & Diehl, PA
700 Home Federal Building
139 South Tryon Street
Charlotte, N. C. 28202
Counsel for Respondent,
Harris Upham & Co., Inc.

APPENDIX A

Opinion of the Court of Appeals
for the Fourth Circuit

---

No. 77-2051

Thomas S. Carpenter and
Elliott Taylor,

Appellants,

v.

Harris, Upham & Company, Inc.,

Appellee.

No. 77-2052

Joseph Warren, III, Mark B. Edwards,
and Edwards & Warren, Professional
Association,

Appellants,

v.

Harris-Upham and Company,

Appellee.

No. 77-2181

Eldo Grogan, William Mills, and
Gene Patton,

Appellants,

v.

Harris, Upham & Company, Inc.,

Appellee.

No. 77-2182

Michael B. Allran, Edward R. Anderson,
A. J. Beall, Jr., Anne C. Hawley,
Barbara Morgan, Robert S. Morgan,
G. F. Parker, Samuel White,



G. F. Parker, Samuel White,
R. W. Cannon, Dominic Capelli,
Pauline Capelli, Frank W. Cayce,
John Gaylor, Jr., John A. Jenks,
Frank Manship,

Appellants,

v.

Harris, Upham & Company, Inc.,

Appellee.

---

O R D E R

The panel as constituted in the above cases has voted to deny the petitions for rehearing filed by all appellants.

The full court has been advised of the petitions for rehearing and no judge of the court has indicated that the petitions be granted.

The petitions for rehearing are DENIED.

FOR THE COURT

/s/ Walter E. Hoffman

Senior United States District Judge*

*Senior United States District Judge for the Eastern District of Virginia, sitting by designation.